No. 93-878

Supreme Court, U.S.
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

HAROLD M. PROVIZER AND JOAN PROVIZER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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REPLY MEMORANDUM FOR THE PETITIONERS

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1. In his Brief in Opposition (p. I), the Solicitor General's formulation of the question presented embraces the position of the court below and the Second and Eighth Circuits, *viz.*, that the Section 6659 overvaluation penalty automatically applies in any transaction that involves "a significant overvaluation *and* lack[s] economic substance" (emphasis supplied). But the Solicitor General errs in his assertion (Br. in Opp. 5) that "[t]he court's decision tracks the language of the statute." Quite to the contrary, his reading seriously distorts the statutory text and has been rejected by both the Fifth and Ninth Circuits. As we have pointed out (Pet. 7-9), Section 6659(a) imposes the penalty where there is "an underpayment of the tax . . . which is attributable to a valuation overstatement" (Pet. App. C 63a). The critical statutory term is "attributable," *i.e.*, there must be a direct proximate causative relation-

ship between the overvaluation statement and the underpayment in tax.

The following hypothetical demonstrates the unsoundness of the government's reading of the statute. Suppose taxpayer A donates a painting to X, a charitable organization. Thereafter, A obtains an appraisal that the painting is worth $10,000 and thereafter claims a charitable contribution deduction in the amount of $10,000. On audit, the Commissioner determines that: (a) the fair market value of the painting is only $1,000; and (b) the transaction lacked economic substance because the taxpayer never properly transferred possession of the painting to the charity. As a result, the Commissioner disallows the deduction.

On these facts, the Section 6659 overvaluation penalty cannot apply because the underpayment of the tax rests upon a ground that is wholly independent of any overvaluation statement, *viz.*, that the transaction lacked economic substance. By the same token, if the donee organization turned out not to be a qualified charity, the result would be precisely the same—disallowance of the deduction but no overvaluation penalty. Any other result would improperly stretch—or as the Second Circuit even conceded, "somewhat strain" [1]—the plain meaning of Section 6659 to apply to any case in which there is an overvaluation statement with regard to the basis or value of property.

Here, too, it is plain that petitioner's overvaluation statement was not the direct cause of the underpayment. Although the Tax Court found that the value of the machine was overstated, it also disallowed the claimed tax benefits on the grounds that the transaction lacked economic substance, business purpose and profit motive (Pet. App. A 51a-58a). Indeed, the government simply ignores

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[1] *See Gilman v. Commissioner*, 933 F.2d 143, 151 (2d Cir. 1991), *cert. denied*, 112 S.Ct. 871 (1992).

our analysis (Pet. 11-12) that if the underpayment in tax in this case were solely "attributable to" the overvaluation statement, the Tax Court would have conformed its decision to its finding that the machine was worth $50,000 and partially allowed the claimed tax benefits. But the Tax Court did not so rule. Rather, it upheld the Commissioner's total disallowance of petitioner's claimed credits. It is therefore clear that the underpayment in tax was not "attributable to" the overvaluation statement. If, as this Court has ruled, " 'penalty statutes are to be construed strictly' " (*Commissioner v. Acker*, 361 U.S. 87, 91 (1959), quoting from *Federal Communications Commission v. American Broadcasting Co.*, 347 U.S. 284 (1954), the Section 6659 penalty cannot apply to such a case.

2. Since this Court previously considered the question presented when the taxpayers in *Gilman* and *Illes* [2] sought certiorari, the issue has assumed far greater significance. Indeed, the Solicitor General does not challenge our submission (Pet. 13-14) with respect to the administrative importance of the question presented in this test case which affects the liabilities of thousands of taxpayers estimated to total $33 million, and its continuing importance as an issue of statutory construction under the Internal Revenue Code (Br. in Opp. 3 n.2, 5 n.3). Instead, he simply argues (Br. in Opp. 7-8) that there is no conflict between the decision below and the comparable transaction in *Heasley v. Commissioner*, 902 F.2d 380 (5th Cir. 1990). But his attempted distinctions between this case and *Heasley* are unavailing. Here, as in *Heasley*, the taxpayer's claimed credits—based upon an overvaluation statement—were totally disallowed. Moreover, here, as in *Heasley*, petitioner's return contained an overvaluation statement upon which tax benefits were claimed. Under the reading of Section 6659 by the Fifth Circuit in

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[2] *Illes v. Commissioner*, 982 F.2d 163 (6th Cir. 1992), *cert. denied*, 113 S.Ct. 1579 (1993).

Heasley, petitioner's underpayment therefore cannot be said to be "attributable to a valuation overstatement." As the court of appeals there stated,

> Whenever the I.R.S. totally disallows a deduction or credit, the I.R.S. may not penalize the taxpayer for a valuation overstatement included in that deduction or credit. In such a case, the underpayment is not attributable to a valuation overstatement. Instead, it is attributable to claiming an improper deduction or credit.

902 F.2d at 383. Thus, the significance of *Heasley* is that the Fifth Circuit rejected the Tax Court's holding—and the decisions of the Second and Eighth Circuits—that the mere existence of an overvaluation statement on a tax return reporting a transaction that lacks economic substance automatically triggers the overvaluation penalty. Given the conflict of decisions on virtually identical facts, the Solicitor General's advice that "the Commissioner does not agree with the seemingly broad language of the *Heasley* decision" (Br. in Opp. 8) hardly constitutes a cogent basis upon which to foreclose review by this Court. Indeed, it is precisely that ruling in *Heasley* that is at odds with the decision below and those circuits it has followed.[3]

3. Finally, the government argues (Br. in Opp. 6-7) that the decision below does not conflict with *Todd v. Commissioner*, 862 F.2d 540 (5th Cir. 1988); and *Gainer v. Commissioner*, 893 F.2d 225 (9th Cir. 1990), because those cases turned on the fact that the property at issue had not been placed in service during the taxable year. In support of this claimed distinction, the government claims (Br. in Opp. 6 n.4) that "The [Tax] court

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[3] There is no justification for the government's claim (Br. in Opp. 8) that "Heasley did not involve a situation in which the taxpayer's return relied on a substantial overvaluation of property in claiming tax benefits from a transaction that the court found lacked economic substance." The Fifth Circuit's opinion in *Heasley* makes it clear that in a transaction, which is in all respects comparable to the transaction at issue in this case, "the Heasleys overvalued each unit by $9500" even though they "were worth about $4800 each." *See* 902 F.2d at 382 and n.4.

made no express findings [in this case] as to when the property was actually placed in service."

This assertion, however, is flatly contradicted by the record. It is beyond question that the Tax Court specifically found that "Two of the machines never worked and remained for most of 1981 through 1985 in a PI warehouse" (Pet. App. B 54a) and this finding was affirmed by the court of appeals (Pet. App. A 4a). With respect to these machines, it is therefore clear that the property was never placed in service because it was not "placed in a condition or state of readiness and availability for a specifically assigned function." Treas. Reg. § 1.46-3(d)(1).[4] Accordingly, the Tax Court made the requisite finding on this point that establishes the conflict between the decision below and *Todd* and *Gainer*. In these circumstances, the Commissioner's disallowance necessarily stands on the additional independent ground that the equipment was not placed in service during the taxable year in which the tax credits were claimed. Under the plain terms of the statute, the Section 6659 penalty is therefore not applicable. *Todd v. Commissioner, supra*; *Gainer v. Commissioner, supra*; *Heasley v. Commissioner, supra.*

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[4] The Solicitor General mischaracterizes our argument with respect to the "placed in service" issue, claiming that we rely on the failure to ship the machines to end-users by the end of 1981 (Br. in Opp. 6 n.4). Quite to the contrary, our argument rests upon the findings of both courts below that the machines were never placed in service because they did not work. Moreover, the Solicitor General errs in his speculation (*id.*) that the Tax Court made no express findings as to when the property was placed in service because petitioner was a "lessor of the equipment." In fact, petitioner was a lessee and a licensor of the machines (Pet. App. A 25a-26a).

CONCLUSION

For the reasons stated above and in the petition for a writ of certiorari, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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